AGENCY COSTS AND THE STRIKE SUIT: REDUCING FRIVOLOUS LITIGATION THROUGH EMPOWERMENT OF SHAREHOLDERS

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7 J. BUS. & SEC. L. 213

TABLE OF CONTENTS

I. INTRODUCTION 213

II. BACKGROUND TO THE PRIVATE LITIGATION SECURITIES REFORM ACT 214

III. CONGRESS, THE PRIVATE SECURITIES LITIGATION REFORM ACT, AND FRIVOLOUS LAWSUITS 217

IV. FAILURE OF THE PRIVATE SECURITIES LITIGATION REFORM ACT TO ENCOURAGE INSTITUTIONAL INVESTORS TO BECOME LEAD PLAINTIFFS 221

V. DIRECTOR/SHAREHOLDER AGENCY COST PROBLEMS 224

VI. CONCLUSION 230

I. INTRODUCTION

Securities regulation is a remarkably complex and contradictory web. Nothing evidences this better than the litigation that emerges from it. Such litigation was presumably intended to empower investors, whose access to truthful corporate disclosures had previously been subject to the whims of those disseminating the information. Yet, while this system was undoubtedly well-intentioned, it has two inherent flaws.

First, securities law encourages the proliferation of "strike suits," which are frivolous claims filed for the purpose of quick settlement. Second, securities law creates an awkward misalignment of interests among the plaintiff class. Unlike most sensible legal schemes, where the person responsible for satisfying some claim is also the person responsible for causing it, under securities law, liability created by corporate officer and director misstatements is largely satisfied by the corporate shareholders. This misalignment of interests produces some perverse results. Most significantly, a shareholder who purchases in reliance on a misstatement by a corporate director may find himself on both sides of the litigation, if the shareholder retains shares in the corporation he is suing.

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Congress amended the lead plaintiff rules in the Private Securities Litigation Reform Act of 1995 (PSLRA) to favor appointment of the investor with the greatest stake in the litigation. Its intention was to reduce the agency monitoring costs that encouraged frivolous lawsuits. Whereas pre-PSLRA, professional plaintiffs had little incentive to monitor frivolous claims, post-PSLRA, Congress believed that empowered institutional investors, with substantial interests in the case as both plaintiff and defendant, would have the incentive to ensure that only meritorious claims were filed.

Congressional intent in this respect has been hampered in two ways. First, though the law provides incentive for lead plaintiffs to monitor their attorneys, it does not provide the incentive for large institutional investors to seek and accept lead plaintiff appointments. And second, congressional intent to encourage participation of institutional investors holding large stakes in the defendant companies has come under increasing challenge in certain courts. These courts believe that the more equitable solution may sometimes be to split plaintiffs who still hold defendant company stock apart from those who no longer hold stock.

This note suggests that the focus on agency monitoring costs between plaintiff and attorney is unnecessary for the achievement of congressional aims. Indeed, equivalent or greater agency costs problems materialize between shareholders and their corporate directors, when the directors are named as individual defendants in a securities litigation against the company. Thus, this note argues that adoption of a precommitment strategy by directors, whereby shareholders are granted the power to sanction securities litigation settlements, is an effective alternative means for fulfilling the congressional intent of limiting frivolous lawsuits.

Section II begins with a brief the history of securities class actions. It then examines how agency cost problems between lead plaintiffs and their attorneys encourage frivolous lawsuits. Section III describes the congressional response to this problem. Specifically, it highlights the connection between the agency cost problem and congressional intent to limit frivolous lawsuits and suggests how the former can help solve the latter. Section IV outlines the failure of the PSLRA to achieve its goal and suggests two reasons for this failure. Finally, Section V argues that directors are ineffective agents of the shareholders in securities class actions. It highlights the competing interests of directors that result in actions against the best interests of the shareholders. Ultimately, this paper proposes precommitment as a more practical response that directors can take to help reduce frivolous litigation.

II. BACKGROUND TO THE PRIVATE LITIGATION SECURITIES REFORM ACT

A. Development of Fraud on the Market Theory

Rule 10b-5 is the most important enforcement provision to emerge from the Securities Exchange Act of 1934. It broadly prohibits “any person” from engaging in various fraudulent activities “in connection with the purchase or sale of any security.” Thus, it creates an implied right of recovery to those plaintiffs who can demonstrate, among other things, reliance on the misrepresentations of a defendant. Yet, at first blush, 10b-5’s remedy seemingly exists only in the theoretical. For, if courts were to require proof of individualized reliance, plaintiffs’ individual issues would overwhelm their common ones, foreclosing the ability of a class

action lawsuit.[1] Relegated to independent lawsuits, the claims of individual plaintiffs would often be too marginal to merit the investment in complex litigation.

This problem was acknowledged by the Supreme Court in *Basic v. Levinson*.[2] There, the Court sanctioned a new theory of reliance that would expand the concept far beyond the traditional realm. This new presumption, titled "fraud on the market," posits that traders of stock in a well-developed market act in reliance on the integrity of its market price.[3] Therefore, a plaintiff purchasing in a well-developed market need not show specific reliance on any misstatement, as he relies on the presumption that all statements were incorporated into the stock price.[4] This development allowed for the aggregation of plaintiffs into classes with multi-million dollar claims, thereby making practical the maintenance of class action lawsuits.[5] The result was a 10b-5 rule with a wider and stronger bite. Indeed, in the three years following *Basic*, the number of class actions filed nearly tripled.[6]

B. The Problem of Strike Suits

Despite these seemingly positive developments, the 10b-5 litigation system remained largely flawed. The pre-*Basic* system had struck an awkward balance between two competing forces that operated simultaneously to limit and encourage securities litigation. While strict pleading requirements artificially limited litigation, the uniquely significant "danger of vexatiousness" present in securities lawsuits operated to artificially inflate the level of litigation.[7] When collective action problems were removed by the Court in *Basic*, the system became vulnerable to substantial increases in litigation.

One notorious form of litigation was the strike suit. A strike suit is defined as litigation, "usu[ally] based on no valid claim, brought either for nuisance value or to obtain a settlement."[8] In the context of securities litigation, a strike suit is manufactured and brought by plaintiff attorneys following a substantial drop in the price of a defendant company. These suits take advantage of the great disparity in litigation costs between plaintiff and defendant, along with the subjective, fact-based standards that impede prompt dismissal of frivolous lawsuits. Although making ex ante determination as to the merits of a settled case is difficult, various scholarly studies have found strike suits to constitute a large percentage of securities class action lawsuits.[9] Indeed, one study found that 40% of all securities lawsuits were settled for less than the defendant's costs of taking a case to trial.[10]

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[1] Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988).
[2] *Id.*
[3] *See id.* at 243-45 (explaining the fraud on the market theory).
[4] *Id.* at 246-47
[5] *See* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions With Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 948-49 (1999).
[6] *See id.* at 949 n.89 (citing Vincent E. O'Brien, The Class-Action Shakedown Racket, Wall St. J., Sept. 10, 1991, at A20).
[7] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975).
[8] Erica Beecher-Monas, *Enron, Epistemology, and Accountability: Regulating in a Global Economy*, 37 IND. L. REV. 141, 177 n.202 (quoting A HANDBOOK OF BUSINESS LAW TERMS 579 (Bryan A. Garner ed. 1999)).
[9] Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 949 (1993) ("[S]tudies by various scholars over the years have revealed that a large percentage of derivative and class actions are frivolous.").
[10] Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2085 (1995).

Outrage over the effects of strike suits led Congress to hold hearings that examined the effects of these suits in the capital markets.[11] Witnesses presented testimony on numerous ill-effects of such suits, including: (1) companies were less likely to disclose information; (2) competent potential directors were less likely to serve on boards; and (3) shareholders who lost money from share price drops were further financially harmed when the lawsuits further depleted the value of their shares, with only minor recovery.[12]

C. Agency Cost Problems in Securities Litigation

Animosity towards plaintiff attorneys had peaked around the time of these congressional hearings. They were widely disparaged for manufacturing lawyer-driven litigation, thus benefiting themselves, while imposing substantial costs on both plaintiffs and defendants. It was at this time that Weiss & Beckerman published their seminal article, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*,[13] which highlighted the opportunistic behavior of many of these lawyers. Weiss & Beckerman argued that such behavior was made possible by agency-cost problems that prevented plaintiffs from adequately monitoring their lawsuits.[14]

An agency-cost problem emerges when a principal faces prohibitive costs in monitoring an agent whose incentives do not wholly align with those of the principal. This occurred in pre-PSLRA securities litigation, because plaintiff attorneys had far more at stake in the litigation than the plaintiffs they purported to represent.[15] Weiss & Beckerman blamed this largely on the prevailing system for the selection of lead plaintiffs.[16] This system allowed "entrepreneurs" to treat lead plaintiff appointments as a vocation by maintaining trivial holdings in an extensive array of stocks. These "professional plaintiffs" did not rely on recovery damages to earn their living; rather, they were compensated "in the form of bounty payments or bonuses."[17] They provided a service to their "employer" attorneys, as their broad shareholdings empowered these attorneys to sue at the drop of a dime.[18]

Pre-PSLRA, little stood in the way of these plaintiffs obtaining lead plaintiff positions, as such positions were usually awarded to the first filers.[19] Once appointed, lead plaintiffs possessed strong incentive to shirk their monitoring duties. They had little if anything to gain

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[11] Julia C. Kou, *Closing the Loophole in the Private Securities Litigation Reform Act of 1995*, 73 N.Y.U. L. REV. 253, 254 (1998) (finding the debate leading to the passage of the PSLRA focused on strike suits).
[12] *See* Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1013 (1996) (summarizing testimony Congress heard during PSLRA hearings).
[13] Weiss & Beckerman, *supra* note 10.
[14] *Id.* at 2126 (highlighting the growing belief that plaintiff attorneys prosecute frivolous securities litigation "without meaningful client supervision and primarily to advance their own interests.").
[15] *Id.* at 2059 ("Attorneys typically have much more to gain from these class actions than do the investors who serve as named plaintiffs.").
[16] *Id.* at 2059-61 (describing how attorneys manipulate the lead plaintiff selection process to maximize agency monitoring costs).
[17] H.R. REP. NO. 104-369, at 32-33 (1995) (Conf. Rep.).
[18] Literally, these attorneys would generally bring suit upon any significant stock drop. Weiss & Beckerman, *supra* note 10, at 2060.
[19] *Id.* at 2062 ("Courts most often appoint as lead counsel the lawyer who files the first complaint.").

by monitoring their attorneys, but had much to lose.[20] If they were perceived by their lawyers as too irksome, these plaintiffs could simply be passed over in the next lawsuit for another of the thousands of shareholders.

The resulting lack of oversight allowed plaintiff lawyers to obtain sweetheart deals at the expense of their clients. For instance, Weiss & Beckerman highlight a provision inserted into settlement agreements that requires plaintiffs to prove actual reliance (as opposed to fraud on the market) to collect from a settlement fund above a certain threshold.[21] Because money left unclaimed from the settlement fund is returned to the defendants, this "collusive" agreement allows plaintiff attorneys to collect fees on the maximum possible damages, with little likelihood that such damages will ever be paid out.[22] Furthermore, securities actions are settled at inordinately high rates.[23] This encouraged unnecessary, unprofessional work by lawyers, who would often delay settlement until the eve of trial, racking up considerable legal fees for relatively simple discovery and motion work.[24]

Weiss & Beckerman believed that this problem could be solved by appointment of the "most adequate" lead plaintiff, rather than the first person to file.[25] They defined the most adequate plaintiff as the plaintiff with the largest financial stake in the outcome of the action.[26] Appointment of such a plaintiff reduces agency costs, because the plaintiff with the largest stake also has the greatest incentive to monitor.[27] Of course, as an added benefit, the largest holder is also often an institutional investor, who brings the "knowledge and financial sophistication necessary to serve as effective litigation monitors."[28]

III. CONGRESS, THE PRIVATE SECURITIES LITIGATION REFORM ACT, AND FRIVOLOUS LAWSUITS

The Weiss & Beckerman article has been widely credited with providing the impetus for Congress to change the lead plaintiff provisions.[29] Indeed, the Senate Report explicitly credits their article with providing the inspiration for the most adequate plaintiff provision.[30] Yet, upon closer examination, the goals of Congress in enacting the PSLRA were actually distinct from those highlighted by Weiss & Beckerman.

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[20] The typical lead plaintiff's stake was too small for him to monitor either the prosecution or settlement of the case. *Id.* at 2064-65.
[21] *Id.* at 2075.
[22] *Id.*
[23] For example, one study found that less than 5% of the securities litigations pending in 1987 ever went to trial. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 525-26 (1991). A smaller study found that 83% of securities cases filed in Dallas federal district court were settled. *Id.*
[24] *Id.* at 544.
[25] Weiss & Beckerman, *supra* note 10, at 2105.
[26] *Id.*
[27] *Id.*
[28] *Id.* at 2126.
[29] *See, e.g.,* R. Chris Heck, *Conflict and Aggregation: Appointing Institutional Investors as Sole Lead Plaintiffs Under the PSLRA*, 66 U. CHI. L. REV. 1199, 1204 (1999) ("In deciding to favor institutional investors as lead plaintiffs, Congress relied on a law review article by professors Elliott Weiss and John Beckerman.").
[30] S. REP. NO. 104-98, at 11 n.32 (1995).

A. Origins of the problem

Congress enacted the PSLRA with the overriding purpose of protecting investors and maintaining confidence in the securities markets.[31] These reforms were a necessary response to congressional findings that the private securities litigation system was being "undermined by those who seek to line their own pockets by bringing abusive and meritless suits."[32] Thus, Congress envisioned the PSLRA as a protection for "investors, issuers, and all who are associated with [the] capital markets" from abusive securities litigation.[33]

One focus of Congress was on the selection of lead plaintiffs. Specifically, Congress found the existence of professional plaintiffs "encouraged the filing of abusive cases."[34] Their proliferation allowed lawyers to quickly bring suit upon a substantial drop in a company's market capitalization, rather than the merits of the individual case.[35] Because defendant companies had a strong propensity to settle these lawsuits without regards for the merits, the lawsuits created a "litigation tax" on business.[36] Victims of these suits received "only pennies on the dollar in damages," with long-term investors bearing the brunt of these extortionate settlements.[37]

One means for Congress to curb abuses of the litigation system, was to alter agency costs of bringing strike suits, by changing the system for awarding the lead plaintiff role from the first plaintiff to file to the plaintiff with the largest financial stake in the relief sought, i.e. the institutional investors.[38] Congress believed that institutional investors would be the most capable of representing the interests of the plaintiffs' class as a whole.[39]

B. Two Types of Agency Cost Problems in Securities Litigation

As aforementioned, Congress and Weiss & Beckerman were each attempting to solve different agency cost problems. These agency problems were caused by two distinct, inefficient types of behavior.[40] The first problematic behavior occurs when a lawyer does too little, either by undervaluing a claim in settlement or by providing to himself a sweetheart deal at the expense of his clients. The second problematic behavior, labeled the "strike suit," occurs when a lawyer does too much, by bringing a non-meritorious claim.

Weiss & Beckerman believed that reducing agency costs would limit the opportunistic behavior of plaintiff attorneys, thus dealing with the problem of the lawyer who does too little.[41] Congress, on the other hand, believed that reducing agency costs could decrease the filing of frivolous lawsuits, thus dealing with the problem of the lawyer who does too much.[42]

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[31] H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.).
[32] *Id.*
[33] *Id.* at 32.
[34] *Id.* at 33.
[35] S. REP. NO. 104-98, at 8-9.
[36] *Id.* at 9.
[37] *Id.*
[38] *Id.* at 11.
[39] *Id.* ("[I]ncreasing the role of institutional investors in class actions will ultimately benefit the class….").
[40] *See* William B. Rubenstein, *Emerging Issues in Class Action Law: The Fairness Hearing: Adversarial and Regulatory Approaches*, 53 UCLA L. REV. 1435, 1441-42 (2006) (outlining the two problematic behaviors).
[41] *See supra* notes 20-24 and accompanying text.
[42] *See supra* Part III.A.

The similarity between these two concepts has caused scholars to sometimes equate them. However, the two are actually quite distinct, and at times contradictory.

C. The Disconnect Between the Two Problems

Weiss & Beckerman's goal of shifting power from lawyer to shareholder is certainly noble. However, it tackles the agency cost problem of limiting opportunistic lawyer behavior, which does not necessarily further Congress's intent of eliminating frivolous lawsuits. One note summed this disconnect up best, stating "[i]n the typical securities class action…the interest of the class - maximizing its recovery - has no necessary relation to the benefit that society receives from the suit - deterrence of securities law violations."[43]

This is certainly true as related to "traditional plaintiffs." Traditional plaintiffs are investors who purchased shares during the class period and sold them following the class period. These plaintiffs are "traditional" because they are unconflicted in the goal of obtaining the largest possible settlement from defendants. Traditional plaintiffs are disadvantaged when their claims are underinvestigated, undervalued, and overbilled.

On the other hand, unique to securities litigation is the presence of plaintiffs whose interest is not always to sue. These plaintiffs, labeled untraditional, are investors who purchased shares during the class period and continue to hold the shares. They are "untraditional" because any recovery to them will be paid out of a cash pool partially owned by them. Thus, unlike traditional plaintiffs, untraditional plaintiffs are harmed when the amount they recover as plaintiffs is less than the amount they must contribute as shareholders to fund the litigation and settlement.

Calculating the resulting harm to untraditional plaintiffs caused by agency problems is made complicated by a confluence of factors. Such plaintiffs are almost always hurt when traditional plaintiffs are hurt, because the money paid to their lawyers is taken from a collective recovery pool.[44] Yet, because of the inefficiencies in the securities litigation system, untraditional plaintiffs will often be hurt even when traditional plaintiffs are not. The greater the transaction costs in relation to the proportionate recovery, the more likely an untraditional plaintiff is to be hurt by the lawsuit.

One clear instance where the interests of traditional and untraditional plaintiffs diverge is the strike suit. These cases are characterized by a low potential of plaintiff recovery and a high potential for substantial lawyer fees.[45] The traditional plaintiff, with no remaining stake in the company, has little incentive to prevent this substantial waste, as any recovery puts him in a better-than-deserved position. Because these plaintiffs always benefit from frivolous lawsuits in the short-run, their best interests in such cases will conflict with the goals of the PSLRA. Thus, a shift in decision-making from plaintiff lawyer to traditional plaintiff will have marginal effect in curbing frivolous litigation.

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[43] Note, *Investor Empowerment Strategies in the Congressional Reform of Securities Class Action*, 109 HARV. L. REV. 2056, 2069 (1996).

[44] However, it is theoretically possible, in a litigation with a large plaintiff class, that a plaintiff lawyer who signs a lowball settlement agreement might actually benefit the untraditional plaintiff as shareholder more than he hurts the untraditional plaintiff as plaintiff.

[45] Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355, 368-69 (1993) ("[A] substantial number of claims are settled in terms that offer the plaintiff shareholders only nonpecuniary relief but award their attorneys substantial legal fees...").

The untraditional plaintiffs, collectively, have a strong interest in preventing such waste, as their expected recovery is more than offset by the costs of litigation and settlement. These plaintiffs are key to the PSLRA statutory scheme, because by shifting power to them, Congress simultaneously altered the ability of lawyers to exploit their clients and the ability of plaintiffs to exploit the system.

D. How the Private Securities Litigation Reform Act Was to Operate to Reduce Agency Costs

The PSLRA lead plaintiff provision was a congressional attempt to harness the power of untraditional plaintiffs to prevent frivolous lawsuits. It requires the court to appoint the "most adequate plaintiff," defined as the plaintiff or group of plaintiffs with the largest financial stake in the relief sought.[46] Congress was aware that these plaintiffs were likely to hold remaining shares in the corporation.[47]

That Congress sought to limit frivolous lawsuits through reduced agency costs is clear from Reports of the Conference Committee and Senate. Congress recognized that, as the largest shareholders in most companies, institutional investors have "the most to gain from *meritorious* securities litigation."[48] However, because, they are also long-term investors with large stakes in many companies, they ultimately have the most to lose from frivolous lawsuits.[49] Thus, with stakes as both plaintiff and defendant to a lawsuit, an institutional investor can "consistent with its fiduciary obligations, balance the interests of the class with the long-term interests of the company and its public investors."[50]

Some congressmen raised the objection that large investors would conspire with the defendant company's management to the detriment of small investors.[51] Congress rejected such a theory, finding references to institutional investors as large investors to be misnomers.[52] Indeed, half the assets of institutional investors were pension funds whose beneficiaries are small investors. Thus, when these large investors act in their best interests, they actually act for the benefit of small investors.[53]

E. Courts Recognition of the Congressional Intent

Courts have by-in-large recognized the intent of Congress, through the PSLRA, to limit frivolous lawsuits. In *Gluck v. CellStar Corp.*,[54] the court considered an adequacy challenge by one group of plaintiffs to the appointment of an institutional investor as lead plaintiff on the grounds that the institutional investor "would litigate the case with an eye toward

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[46] S. REP. NO. 104-98, at 11.
[47] *See In re* Cendant Corp. Litig., 264 F.3d 201, 243-244 (3d Cir. 2001) ("The plaintiff with the largest stake in a given securities class action will almost invariably be a large institutional investor, and the PSLRA's legislative history expressly states that Congress anticipated and intended that such investors would serve as lead plaintiffs.").
[48] S. REP. NO. 104-98, at 11 (emphasis added).
[49] *Id.* at 9.
[50] *Id.* at 11.
[51] H.R. REP. NO. 104-369, at 34 (Conf. Rep.).
[52] *Id.*
[53] *Id.*
[54] 976 F. Supp. 542 (N.D. Tex. 1997).

balancing the long term interests of [the defendant corporation] with the interests of the class."[55] The court found that maximization of plaintiff class return is not necessarily achieved by extorting the largest possible damages payment. Rather, forgoing a substantial short-term settlement, could improve a company's chances at experiencing future growth.[56] This delicate balancing is best done by institutional investors, rather than the lawyers of professional plaintiffs, who will always seek maximum damages.[57]

This was explicitly adopted by the Third Circuit in *In re Cendant Corp. Litig.*[58] There, appointment of a large institutional investor (CalPERS) as lead plaintiff was challenged because it continued to hold a large stake in the defendant company. The court found the argument "attractive," but ultimately unpersuasive.[59] It determined that Congress was well aware that the largest institutional investor often maintains a stake in the defendant company.[60] Thus, congressional preference for these institutional investors is evidence of the congressional belief that such a circumstance "does not inherently create an unacceptable conflict of interest."[61]

IV. Failure of the Private Securities Litigation Reform Act to Encourage Institutional Investors to Become Lead Plaintiffs

A. Frivolous Lawsuits Are Still Prevalent

It is extremely difficult to measure the frequency of frivolous lawsuits under a system where most cases are inevitably settled before a trial can ever decide the merits. The data does show that the frequency of securities lawsuits has increased post-PSLRA.[62] Thus, we can make the preliminary assumption that if the number of meritorious claims has not substantially increased – and the increased overall deterrence of lawsuits present in the PSLRA makes this likely – the number of frivolous claims has not decreased.

One clever way for measuring the percentage of frivolous lawsuits is to examine the size of settlements pre and post-PSLRA. If the number of frivolous lawsuits filed has actually decreased following the PSLRA, the size of settlements should have consequently increased.[63] Two studies fail to find any such correlation. One study, by Cox & Thomas found no significant difference in the size of pre and post-PSLRA settlements, after controlling for provable losses, market capitalization of the defendant companies, the length of the class period, and the presence of a parallel SEC action.[64] This showing was replicated in an upcoming study by Johnson, Nelson & Pritchard, which found the median settlement to

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[55] *Id.* at 548.
[56] *Id.*
[57] *Id.*
[58] 264 F.3d 201 (3d Cir. 2001)
[59] *Id.* at 243.
[60] *Id.* at 243-44.
[61] *Id.* at 244.
[62] Marilyn F. Johnson, Karen K. Nelson & Adam C. Pritchard, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. at 3 (forthcoming Oct. 2007).
[63] James D. Cox & Randall S. Thomas, *Litigation Reform Since the PSLRA: A Ten-Year Retrospective: Panel One: Private Securities Litigation Reform Act: Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1628 (2006).
[64] *Id.* at 1628-29.

actually be lower in post-PSLRA cases.[65] This despite the fact that "sued firms experience unusually large single-day stock price drops, particularly in the post-PSLRA period."[66] Nevertheless, the Johnson, Nelson & Pritchard study has been cited for the proposition that "settlements after the enactment of the PSLRA include a higher percentage of meritorious litigation."[67] This is due to unjustified suggestions by the authors that their study reveals such correlation.

The Johnson, Nelson & Pritchard study finds a substantially higher correlation between lawsuit filings, accounting restatements, and abnormal stock sales in the post-PSLRA period.[68] It also finds substantially lower correlation between lawsuit filings and forecasts of negative and positive earnings news in the post-PSLRA period.[69] The authors suggest this shows that fraud plays "a more important role in explaining the incidence of… litigation post-PSLRA."[70] However, this is far more logically explained by the PSLRA protection of forward-looking statements and the heightened pleading requirements. The authors also claim that the PSLRA may have increased the likelihood of dismissal of frivolous lawsuits.[71] Yet, peculiarly, the authors include "nuisance" lawsuits in their definition of dismissal, which are defined as lawsuits "settled for a small fraction of the firm's market value."[72] Of course, nuisance is just another word for frivolous. It is hardly proper to include frivolous settlements in the measure of dismissed cases.

B. Financial Institutions Have Been Reluctant to Seek Appointment as Lead Plaintiff

Institutional investors responded extremely slowly to the congressional PSLRA call. Estimates from 2001 placed institutional investors in only 5-10% of all securities litigations.[73] Recently, however, there has been a strong upsurge in union and pension fund lead plaintiff appointments. Whereas their participation rate was only 6% (47/788) between 1995-99, between 2003-04, their participation rate was 32% (120/379).[74] This notable rise in participation may, however, be more connected to their concurrently increasing interest in shareholder activism.[75] Securities lawsuits provide these unions and pension funds additional muscle in their push for corporate change, which can be effectuated through non-monetary settlement provisions.

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[65] Johnson, Nelson & Pritchard, *supra* note 62, at 18. However, the mean settlement was higher. *Id.*
[66] *Id.* at 21.
[67] Stephen J. Choi & Robert B. Thompson, *Litigation Reform since the PSLRA: A Ten-Year Retrospective: Panel One: Private Securities Litigation Reform Act: Securities Litigation and its Lawyers: Changes during the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1500 (2006).
[68] Johnson, Nelson & Pritchard, *supra* note 62, at 20.
[69] *Id.* at 21.
[70] *Id.* at 28.
[71] *Id.* at 3.
[72] *Id.* at 25.
[73] Cox & Thomas, *supra* note 63, at 1590.
[74] *See* PricewaterhouseCoopers LLP, 2005 Securities Litigation Study 8, 21 (2006), available at http://www.pwc.com/extweb/onlineforms.nsf/weblookup/USENGADVOAdvisoryDocumentRequest?opendocument&sandpfile=SecLitStudy_2005_Final.pdf
[75] *See, e.g.*, Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998) (discussing the rise in shareholder activism among labor unions and their pension funds).

Increased pension and union activism contrasts sharply with the largely stagnant 13% participation rate among institutional investors (excluding public pension funds) during the 2003-04 timeframe.[76] These institutional investors have been reluctant to accept lead plaintiff appointments because of the substantial potential costs they would face. Most obviously, these include the reimbursable and non-reimbursable costs of monitoring the case. However, institutional investors also potentially face the broader and more ominous threat of: (1) discovery into their business; (2) disclosure of proprietary nonpublic information; (3) lawsuits by other disgruntled plaintiffs; (4) constraint on the their trading abilities due to receipt of inside information; (5) loss of preferential access to information from defendant companies; and (6) political pressure.[77]

Furthermore, institutional investor lead plaintiffs may not be as effective in eliminating conflicts as Congress intended, for they themselves face significant conflicts. Namely, banks, mutual funds, and insurance companies all sell services to the very companies they are asked to prosecute.[78] Thus, each institution is understandably hesitant to adopt an aggressive position against either present or potential clients.[79] Indeed, data analyzed by Cox & Randall contains "no settlement where a bank, mutual fund, or insurance company has served as a lead plaintiff in a securities class action."[80]

C. Potential Conflict with the Federal Rules of Civil Procedure

Besides satisfying the requirement of having the largest financial interest, the most adequate plaintiff must also satisfy the requirements of Federal Rule of Civil Procedure (FRCP) 23.[81] FRCP 23 is the rule governing class actions and includes guidelines for class certification. Specifically, FRCP 23(a)(4) provides that for one member to sue on behalf of the class, that member must, among other things, fairly and adequately protect the interests of the class.[82]

Some courts have distinguished between the guidelines the PSLRA provides on lead plaintiff appointments and the guidelines FRCP 23 provides on class certification.[83] Thus, while these courts will not reject a lead plaintiff on grounds of adequacy, they will consider plaintiff challenges to the joint class certification of traditional and untraditional plaintiffs. As the court in Cendant stated "the issue is whether the conflict between the interests of Sell Plaintiffs and Hold Plaintiffs in a particular case is sufficiently severe so as to prevent a putative class from satisfying Rule 23's requirements for class certification."[84]

Few securities class actions have actually gone so far as to consider intraclass disputes between traditional and nontraditional plaintiffs.[85] Those that have rarely find them to

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[76] *See* PricewaterhouseCoopers LLP, 2004 Securities Litigation Study 15 (2005), available at http://www.pwc.com/gx/eng/cfr/gecs/pwc_2004_seclit_study.pdf
[77] Cox & Thomas, *supra* note 63, at 1602-03.
[78] *Id.* at 1609.
[79] *Id.*
[80] *Id.*
[81] 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (2005).
[82] *Id.*
[83] *Cendant*, 264 F.3d at 244 n.25.
[84] *Id.*
[85] William B. Rubenstein, *A Transactional Model of Adjudication*, 89 GEO. L.J. 371, 407 (2001).

preclude class certification.[86] Nevertheless, the explicit language of some circuit opinions has left open the opportunity for district court judges to exercise their wide discretion in certifying separate classes or subclasses.

This is troubling, because the judicial determination of whether the conflict between traditional and nontraditional plaintiffs is substantial enough to preclude joint certification is subject to no real oversight or guidance. The plaintiff class in every securities case will be comprised of both traditional and untraditional plaintiffs. Letting individual judges make the determination of when these plaintiff interests sufficiently diverge will only result in confusion. It will also create a slippery slope towards further division. For, if the interests of plaintiffs who sold all of their shares are sufficiently distinct from those who hold all of their shares, certainly plaintiffs who sold only half of their shares cannot be fairly placed into either group. Furthermore, even among two plaintiffs who have not sold a single share, and each hold 10,000 shares, the plaintiff whose shares were wholly acquired within the class period has a very different interest from the plaintiff who acquired only one-quarter of his shares during the class period.

V. DIRECTOR/SHAREHOLDER AGENCY COST PROBLEMS

It remains to be seen whether judges will fully recognize the congressional intent to limit frivolous securities lawsuits by reducing the shareholder monitoring costs of their lawyer agents. Nevertheless, companies need not wait for a more favorable judicial decision nor a more precise congressional statute. This paper proposes that companies can deter strike suits by reducing the shareholder monitoring costs of their corporate director agents. These directors, like plaintiff attorneys, are in the awkward position of having to balance their personal interests in settling cases discreetly against the shareholder interest of minimizing total lawsuit exposure. Thus, these directors too often sit opposite opportunistic attorneys, willing to reward the frivolous lawsuits they bring.

A. Concept of Precommitment

This paper proposes an independent and powerful strategy for use by the enterprising director in counteracting the agency cost problems responsible for these frivolous claims. This strategy is called precommitment, or self-disablement. One often recounted precommitment strategy was employed by Odysseus in Homer's epic, the Odyssey.[87] There, Odysseus, who had been sailing on a journey, was confronted by Sirens, whose beautiful melodies were notorious for luring sailors to their deaths on the rocky shorelines of their islands.[88] Because Odysseus desired to here these melodies, but not to die, he had his sailors tie him to the mast of the ship, and plug their own ears with wax.[89] This allowed Odysseus the benefit of hearing the Sirens' songs, while preventing the poor decision that such heed would have normally caused him to make.[90]

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[86] *Id.*

[87] *See* Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 Iowa J. Corp. L. 1, 1 (2003) ("In The Odyssey, Homer tells a story illustrating the use of a precommitment strategy to achieve a desired goal.").

[88] *Id.*

[89] *Id.* at 1-2.

[90] *Id.*

Use of precommitment strategies is by no means foreign to Boards of Directors.[91] However, the precommitment devices traditionally employed by directors have been unique in that they are intended to bind the company's shareholders more so than its directors. The most prevalent precommitment device, the poison pill, is a weapon employed by directors to prevent hostile takeovers. In its modified form, the poison pill generally grants shareholders of a target company the right to buy discounted shares of the target company, upon the occurrence of a certain event, unless the board redeems the pill.[92] Because these pills can be redeemed by directors, they have little effect in binding them, but substantial effect in preventing shareholders from receiving offers without director consideration.[93] Other pills are sometimes more difficult for directors to redeem, but nevertheless showcase the same motivation of binding the shareholders. For example, in *Moran v. Household International*,[94] the court sanctioned a bifurcated poison pill plan. The redeemable pill was triggered by a tender offer for 30% or more of the company's stock, while the nonredeemable pill was triggered by the purchase of 20% or more of the company's stock. Its purpose was to discourage hostile acquisitions and encourage friendly deals.[95]

Though precommitment strategies have operated to disempower shareholders, this need not be the case. Empowering shareholders by requiring the ratification of select director actions can be an effective means of limiting agency costs in certain circumstances. Precommitment can be effective because it reduces the principal-shareholder's costs of monitoring the agent-director.[96] By giving shareholders the right to ratify the settlement of certain lawsuits at certain stages of the litigation, a board of directors can effectively tie itself to the mast and avoid making the poor litigation decision that might otherwise be precipitated by the individual directors' personal interests.

B. Directors Are Agents of the Shareholders

The Board of Directors is vested in all 50 states with the power to manage the corporation.[97] This is an extremely broad grant of authority, extending to most all corporate decisions.[98] Yet, while directors are delegated substantial powers, they nevertheless owe duties of care and loyalty to the shareholders in exercise of those powers. The duty of care requires that directors obtain sufficient information to be reasonably informed in their decision-making.[99] The duty of loyalty requires the undivided loyalty of directors to the corporation, by putting the corporate interests over their own self interests.[100] Director responsibilities include making litigation decisions for the corporation.

Shareholders unhappy with the Board of Directors have many opportunities to vote their minds. Shareholders have the right to approve fundamental changes, such as mergers. For non-fundamental changes, shareholders can voice their opinions through adoption of bylaws

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[91] *Id.* at 2-3.
[92] *Id.* at 11.
[93] *Id.* at 10.
[94] 500 A.2d 1346 (Del. 1985).
[95] Bainbridge, *supra* note 87, at 12.
[96] *Id.* at 6-7.
[97] DAVID A. DREXLER ET AL., 1-4 DELAWARE CORPORATION LAW AND PRACTICE § 4.01 (2005).
[98] *Id.*
[99] Moran v. Household International, Inc., 490 A.2d 1059, 1075 (Del. 1985).
[100] Guth v. Loft, Inc., 5 A.2d 503, 511 (Del. 1939).

and certificate of incorporation amendments, or through precatory resolutions, which carry no formal weight, but put directors on notice of shareholder unease.[101] Finally, shareholders can vote to replace directors who are up for reelection,[102] or more radically, they can remove underperforming directors mid-term.[103] In Delaware, directors can be removed at any time, with or without cause.[104]

The traditional view holds that the directors are "agents of the shareholders, with fiduciary obligations to maximize shareholder wealth."[105] While this view came under fire by proponents of the managerialist model, who would have given directors independent autonomy over corporate affairs, the traditional model remains today the central mode of analysis, while the managerial theory is all but antiquated in legal scholarship.[106]

This traditional view was adopted by the Supreme Court in *Rogers v. Hill.*[107] There, the Supreme Court considered a shareholder's contention that "excessive" director bonuses should be returned, because they were paid pursuant to a bylaw that had been adopted by shareholders using a power they had previously delegated to the directors. The Court rejected this contention, finding that even though shareholders had delegated the power to adopt bylaws to directors, nevertheless, "[i]t would be preposterous to leave the real owners of the corporate property at the mercy of their agents."[108]

Likewise, the traditional view was adopted by the Delaware Court of Chancery in *Blasius Industries v. Atlas*.[109] There, the court considered whether directors violated their fiduciary duties to shareholders by increasing the size of the Board to prevent a dissident, unaffiliated majority of shareholders from electing a new majority of directors. The court rejected the directors' contention that they were acting in the best interests of the shareholders, declaring, "[t]he theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters."[110]

C. Directors are Poor Agents of Shareholders in Securities Litigation

In the context of securities litigation, directors are particularly poor agents of shareholders, because their risk adverseness provides them with the overwhelming incentive to settle.[111] Directors are always named as defendants to a securities lawsuit. This, despite the limited resources they possess to satisfy any judgment. Plaintiff lawyers likely name directors as defendants to harness this risk averseness and promote quicker and more favorable settlements.[112]

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[101] *See* SEC Rule 14a-8 (addressing when companies must include shareholder proposals in their proxy statements).
[102] *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b)(2007); NY CLS BUS CORP § 602(b)
[103] *See, e.g.,* tit. 8, § 141(k) (directors may be removed with or without cause); NY CLS BUS CORP § 706(a) (directors may be removed for cause);
[104] tit. 8 , § 141(a).
[105] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 548 (2003).
[106] *Id*. at 549.
[107] 289 U.S. 582 (1933).
[108] *Id.* at 589 (quoting *In re.* A.A. Griffing Iron Co., 63 N.J.L. 168, 171 (1898)).
[109] 564 A.2d 651 (Del. Ch. 1988).
[110] *Id.* at 663.
[111] Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 57 (1991).
[112] Alexander, supra note 23, at 530.

Initially, directors are not harmed in any monetary way by securities lawsuits. Their legal costs are covered by liability insurance purchased by their companies.[113] This insurance also indemnifies directors from settlements and, at least technically, damage awards at trial.[114] Yet indemnification of damage awards is not definite, because the policy subjects such indemnification to various exclusions, including exclusion for dishonest actions by the directors.[115] Thus, a single unfavorable judgment has the potential to wipe out a lifetime of a director's earnings, leaving the generally older director with little hope of reamassing such substantial wealth.[116] This "potential liability is vastly disproportionate to the economic benefit they receive from the company."[117] Because a determination of exclusion for dishonesty is only possible upon adjudication, directors have a substantial interest to settle cases, thereby eliminating any possibility of personal liability.[118] Additionally, these directors are sensitive to the reputational injuries that are consequent to the publicity surrounding a large trial.[119]

Though these directors act for the entity corporation as agents of the shareholders, one would be remiss to neglect the influence that their personal pocketbooks wield in using their power. Indeed, as plaintiff attorneys hope, and as is likely plausible, such corporate directors may "apply their individual risk preferences, even if unconsciously, in making decisions for the entity about whether to settle the case or risk a trial."[120] Furthermore, by altering the risk preferences of a company, the plaintiff attorney is also able to increase bargaining leverage.[121]

The PSLRA did not address the agency cost problems inherent in this situation. Rather, some commentators even suggest that the PSLRA aggravated the situation by further increasing agency costs for shareholders in monitoring corporate directors by increasing the pleading burden on plaintiffs bringing claims.[122] Making it more difficult for plaintiffs to bring nonfrivolous claims also makes it easier for directors to further shirk their responsibility to act in the shareholders' best interest.

While these directors would theoretically be accountable to the shareholders for their selfish actions, the ability for shareholders to actually hold directors to account "is largely a myth."[123] Such attempts are "extremely rare" even in perpetually underperforming companies.[124] Indeed, one study found only ten such contests occurred in companies with

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[113] Romano, *supra* note 111, at 57.
[114] *Id.*
[115] *Id.*
[116] Alexander, *supra* note 23, at 531.
[117] *Id.*
[118] Romano, *supra* note 111, at 57.
[119] Alexander, *supra* note 23, at 532.
[120] *Id*.
[121] *Id*.
[122] *See, e.g.,* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 136-37 (2004) ("In the [PSLRA] Congress… legislated severe restrictions on securities fraud class actions, perhaps at the expense of permitting managerial agency costs to rise precipitously."); Jeremiah C. Humes, *Macroeconomic Analysis of the Law: The Missing Piece of the Law and Economics Puzzle*, 42 WASHBURN L.J. 957, 979 (2004) ("[T]he PSLRA made securities actions so difficult to maintain that executives no longer feared being held liable through a successful suit.").
[123] Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003).
[124] *Id*.

market capitalizations over 200 million dollars in a seven year period.[125] Thus, directors, like plaintiff lawyers, generally have the power to act virtually unmonitored.

D. Victims of Director/Shareholder Agency Cost Problems

The losers here are clear both in the short and long-term. In the short-term, injured investors are shareholders of the defendant company, who neither purchased nor sold shares during the relevant class period. These investors are in the unfortunate position of receiving no gains from the misrepresentation, yet bearing the full brunt of any loss in stock price resulting from the fraud. Conversely, there is one distinct short-term winner, besides the lawyers. Namely, the shareholder who sells but does not purchase during the class period reaps a windfall by receiving at an artificially high price, thus capturing the full plaintiff loss, while completely immune from lawsuit.

However, in the long-term, it is investors as a whole that lose.[126] Because the selling shareholder is immune from lawsuit, the buying plaintiffs must seek recovery from other sources. The largest of these sources is the company, i.e. the remaining shareholders. This creates a system whereby company shareholders pay plaintiffs for the windfall profits secured by selling shareholders. In absence of transaction costs, this three-way arrangement would result in a long-term equilibrium where no one profits and no one loses. However, because of large transaction costs, in the form of plaintiff and defendant lawyer fees, substantial value is lost each time this game is repeated. Thus, it would be in the shareholders' interest to minimize the numbers of such lawsuits.

E. Proposal

The proposal of this section is simple and flexible. It is that a precommitment by the board of directors to transfer settlement power in securities fraud cases to the shareholders can be an effective means for reducing frivolous lawsuits. Whereas previously, lawyers brought claims partially in reliance on the supposition that the board of directors desired to settle, lawyers for frivolous claims now would be deterred by the dubiousness of a quick and easy recovery. This deterrence has the advantage of weeding out the meritless claims, while maintaining the incentive for determined lawyers to bring meritorious claims.

Furthermore, because this would not be a legal rule, it is open to tailoring to the individual needs of a company. Thus, for example, a technology company, with the greatest fear of frivolous lawsuit, might seek to delegate most substantially to the shareholders, while a huge corporate conglomerate may be more conservative in its approach. The possibilities for such a proposal are numerous. For the sake of illustration, one such proposal might read as follows:

> In the event that Corporation XYZ and at least one of its directors or officers are sued for violation of the securities law, any decision by the board of directors to settle is subject to ratification by a majority vote, if the lead plaintiff is not the plaintiff with the most substantial financial stake in the litigation.

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[125] *Id.*

[126] "Even worse, long-term investors ultimately end up paying the costs associated with the lawsuits." S. REP. NO. 104-98, at 9 (1995).

A proposal similar to the one above would serve three important policy goals. First, it would encourage shareholders to hold shares, rather than sell them immediately upon bad news, and thereby cause a far more substantial stock overreaction than is otherwise warranted. Second, it would allow for those actually responsible for satisfying the settlement, the shareholders, to determine whether it is in their best interests. And third, it would effectuate the public policy emphasized by Congress in the PSLRA that the interests of the corporation be balanced with those of the plaintiff class. This is especially important in circumstances where the lead plaintiff, for whatever reason, is not a shareholder in the defendant corporation.

F. Legality of Such Delegation

Whether a transfer of settlement authority from the Board of Directors to the shareholders is legal has not been directly addressed in the literature. Nevertheless, based on other concepts present in the Delaware legal scheme,[127] it is clear that Delaware would sanction such a delegation, especially in a situation where the directors themselves are self-interested.

Limits of director delegation abilities are outlined in Section 141(a) of the Delaware General Corporate Law. Section 141(a) states, "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."[128] This power cannot be transferred by "wholesale delegation" to others, including shareholders.[129] Thus, in *Paramount Communications v. Time*,[130] the Supreme Court of Delaware considered whether the defendant was warranted in adopting defensive measures to protect a friendly merger from a hostile tender offer by the plaintiff. The Court permitted the defensive measures, even though the measures prevented the plaintiffs from receiving a control premium "in the immediately foreseeable future."[131] The Court found it to be the duty of directors to select a time frame for achievement of corporate goals and such a duty "may not be delegated to the stockholders."[132]

However, under Delaware law, shareholder ratification is not only allowed, but actively encouraged in certain situations. For example, upon shareholder approval, Section 144(a)(2) of the Delaware General Corporate law immunizes voidable contracts between two corporations or organizations, involving self-interested directors, from voidability.[133] Thus, Section 144(a)(2) simultaneously recognizes the danger involved with giving directors sole decision-making power in situations where they are self-interested and the ability of shareholders to sanction the actions of these self-interested directors. Directors named as codefendants in securities actions with the corporation they manage are as self-interested as

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[127] For purposes of this section, we will consider Delaware law.
[128] DEL. CODE ANN. tit. 8, § 141(a).
[129] DAVID A. DREXLER ET AL., 1-13 DELAWARE CORPORATION LAW AND PRACTICE § 13.01 (2006).
[130] 571 A.2d 1140 (Del. 1989).
[131] *Id.* at 1154.
[132] *Id.* (citing Smith v. Van Gorkom, 488 A.2d 858, 873 (1985)).
[133] "Voidable acts are those acts which are performed in the interest of the corporation but beyond the authority of management and are not classified as being void." Mary A. Jacobson, *Interested Director Transactions and the (Equivocal) Effects of Shareholder Ratification*, 21 DEL. J. CORP. L. 981, 992 (1996) "Void acts include those acts which can be classified as a gift or waste of corporate assets, ultra vires, or fraudulent." *Id.* at 991 (citing Michelson v. Duncan, 407 A.2d 211, 219 (1979)).

those directors who negotiate voidable contracts. These directors have substantial incentives to settle and avoid personal liability, which causes them to act contrary to the best interests of the shareholders. Giving shareholders approval over a settlement agreement negotiated by self-interested directors is no different than giving shareholders approval over a contract negotiated by self-interested directors.

Admittedly, Section 144(a)(2) speaks only to the legal authority resulting from a specific type of shareholder vote. It does not propose to encompass the entire field of shareholder ratifications. Yet, shareholder ratification need not only act to confer legal authority; rather, ratification may be used by shareholders to affirm that an action taken is consistent with their best interests.[134] Indeed, the concept of ratification is itself derived from the common law of agency.[135]

Yet, beyond this, shareholders have specifically been given substantial monitoring power in the litigation context of derivative lawsuits. Derivative lawsuits are brought on behalf of the corporation by its shareholders;[136] meaning, any subsequent recovery accrues wholly to the corporation and not directly to the individual shareholders. Despite the pursuit of such lawsuits being a clear management function within Section 141(a), "equity courts have recognized for at least a century that stockholders should have a means to redress injuries inflicted upon their corporation where management wrongfully refuses to seek recovery."[137]

If shareholders have participation rights in litigation where the corporation is a plaintiff, it is only logical that they should have a similar right in litigation where the corporation is a defendant. Granting shareholders the right to monitor litigation against the company will help solve the same agency problems present in derivative lawsuits that prevent the directors from acting in the shareholders interests.

Finally, consistent with Section 141(a), a corporation can always amend its certificate of incorporation to provide for shareholder voting. Although such a process is quite complex for public companies, it is far easier for private companies with concentrated control. These companies might vote to amend their certificate of incorporation before an initial public offering.

VI. CONCLUSION

The PSLRA was an angry and direct response by Congress to the problem of frivolous litigation. Thus, we should be careful to preserve its motivating intent. Congress intended that the PSLRA be a powerful tool for plaintiffs to use in monitoring their attorneys, by increasing plaintiffs' abilities and incentives to act in their own best interests. Yet, as we have seen, plaintiffs may be conflicted in ways that either encourage frivolous lawsuits or discourage meritorious lawsuits. Divested shareholders have no incentive to limit frivolous litigation, as its costs are wholly borne by others. Similarly, financial institutions have little incentive to prosecute meritorious claims, as they would be suing either present or potential clients, which is quite the irrational business practice.

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[134] Lewis v. Vogelstein, 699 A.2d 327, 334-35 (Del. Ch. 1997) ("[T]he effect of informed ratification is to validate or affirm the act of the agent as the act of the principal.").
[135] *Id.* at 334.
[136] DAVID A. DREXLER ET AL., 2-42 DELAWARE CORPORATION LAW AND PRACTICE § 42.01 (2006).
[137] *Id.*

Therefore, because institutional investors may be either unwilling or unable to act, directors must be proactive in protecting the interests of their shareholders. Odysseus had himself tied to the mast for selfish reasons – to hear the Sirens without dieing. Directors have until now used precommitment for similar purposes – to act as they please without the possibility of rebuke from shareholders. Directors can change this course by allowing shareholders a more meaningful voice in situations where directors are most conflicted.